2021 Global Private Equity Outlook

Dechert LLP

Mergermarket
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Contents

Methodology

In the third quarter of 2020, Mergermarket, on behalf of Dechert LLP, surveyed 100 senior-level executives within private equity (PE) firms based in North America (45%), EMEA (35%), and Asia-Pacific (20%). In order to qualify for inclusion, the firms all needed to have US$500m or more in assets under management and could not be first-time funds. The survey included a combination of qualitative and quantitative questions, and all interviews were conducted over the telephone by appointment. Results were analyzed and collated by Mergermarket, and all responses are anonymized and presented in aggregate.

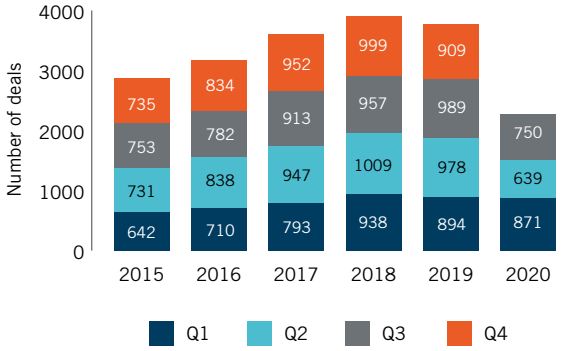
Introduction: Silver linings

The global PE industry experienced a short, sharp shock towards the end of Q1 and going into Q2 as a result of the COVID-19 crisis. Although the pandemic rapidly knocked most auction processes off course, the effects were seemingly momentary. Already, many of the transactions that were put on hold back in March and April have come back and buyout activity has risen above last year's quarterly value in Q3, and the number of notable deals announced in September indicates forward momentum as we enter into the last quarter of the year.

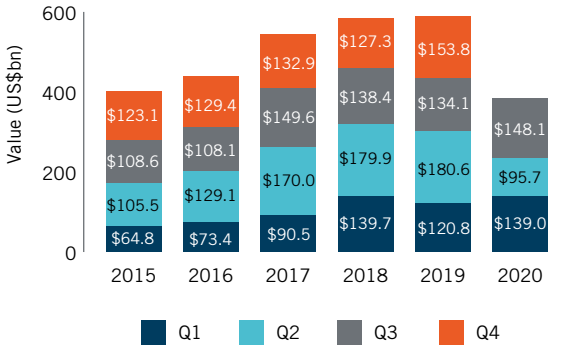
As the pandemic hit the market at the end of Q1, GPs faced the challenge of stabilizing their existing portfolio companies as a first priority, drawing under existing revolving credit lines and providing follow-on financing where necessary and applying strategic and operational lessons learned in the last downturn to steady the ship. With the economic outlook uncertain and fair value of assets difficult to determine, transactions were put on pause—total buyout value fell 22% year on year in the first half of the year, to a total of US$234.7bn.

Given the availability of financing at almost pre-COVID-19 levels and terms and the PE industry's historic levels of unallocated capital, however, deal activity was bound to pick up again. By summer, the public health situation had stabilized in many parts of the world and PE houses turned their eyes towards deals once again: in Q3, total value rebounded to US$148.1bn—10% higher than Q3 2019 (US$134.1bn).

NUMBER OF GLOBAL BUYOUT DEALS, 2015 – Q3 2020



VALUE OF GLOBAL BUYOUT DEALS, 2015 – Q3 2020



In particular, the industrial and chemicals sector, along with the pharma, medical and biotech and the TMT sectors, have fared the best, seeing total value over Q1–Q3 increase on the previous year.

Whether this rate of activity will continue apace to the end of the year remains to be seen. The PE industry faces a number of tough challenges ahead. Protectionism in both trade and foreign direct investment is the highest it has been in a generation and tensions between China and the US have only worsened in 2020. The US elections and Brexit are further potential dampeners of activity, and a second wave of the pandemic has led to new lockdown measures in many countries.

Government and central bank stimulus programs to buttress economies have eclipsed that seen during the Great Financial Crisis (GFC), suppressing yields and forcing investors into higher-risk assets. This has led to the fastest bear market and recovery on record, led by the technology and life sciences sectors' huge success amidst lockdown conditions.

For private market fund managers, the mixed signals of an economic retraction and highly bifurcated market have presented a number of challenges, including revenue forecasting, making realistic portfolio valuations and pricing both acquisitions and exits. Nevertheless, the rise in activity in Q3 demonstrates how adaptive the PE industry can be.

In the long term, PE stands to benefit from the sustained low-rate, low-yield environment, as it has in the years following the GFC. The PE industry has been shown to outperform public markets in a downturn and this one should prove no different—especially considering the industry's war chest of US$1.7 trillion in dry powder.

In the shorter term, the industry must navigate what are sure to be choppy waters by formulating innovative strategies and finding value amidst a downturn. Previous editions of the Global Private Equity Outlook have shown a willingness on the part of respondents to diversify into other asset classes and embrace creative deal structures, and this year is no different. Rather than retrench into comforting formulas, the PE industry recognizes the importance of responding to the market opportunistically—which bodes well for the asset class's resiliency during this uncertain period.

Key findings

PE buyouts remain resilient

Although activity dropped year on year (YOY), the fall in activity was less steep than overall M&A. Across the first three quarters, PE buyouts fell by 21% in terms of volume and by 12% in terms of value in Q1–Q3 2020 to 2,260 deals worth US$382.7bn. In contrast, overall M&A volume dropped by 27% while value fell 28% over this same period. Moreover, Q3 recorded an impressive US$148.1bn in PE deal activity—a 10% year-on-year rise—although volume over this period dropped 24% to 750 deals.

Geopolitical concerns loom large

Among APAC-based respondents, trade conflict between the US and China is expected to have the biggest impact on the deal environment in the coming 12-18 months. 25% of respondents ranked this as the number one concern—more than the number of respondents who thought COVID-19 would have the biggest impact (20%). In North America, 27% of respondents ranked partisan political gridlock number one as having the biggest expected impact on deal environment, just below the 33% who believed the pandemic would have the biggest impact.

Potential impacts of the COVID-19 pandemic are on respondents' minds

90% of respondents expect more distressed debt deals and 80% expect more deal delays as a result of the pandemic. 44% of respondents believe the crisis will affect the PE industry more severely than the GFC.

Buy-and-build deals are on the upswing

The number of add-on acquisitions increased 28% YOY in the first three quarters of 2020, with 1,249 such deals announced. The size of these deals appears to be smaller, however, as total value during this period came to US$32bn—29% below the same period in 2019.

Fund trends: A slight pause

Private equity fundraising has had an incredible run. Annual aggregate capital raised over the past decade has reached heights the industry has never previously seen. For each of the past three years, for instance, funds surpassed US$600bn, according to Preqin—an unprecedented feat. All told, GPs now collectively steward US$3.8 trillion in assets, including both dry powder and invested capital.

Against that backdrop, the events of 2020 have undoubtedly been felt in the fundraising market, but not to the extent that some may have anticipated. Q1 2020 was largely unaffected by the then emerging pandemic. Q2, on the other hand, saw $116bn in aggregate capital raised, the lowest sum since Q1 2018 ($110bn), Preqin data shows. This was shared across 225 fund closes, the lowest tally going back at least five years.

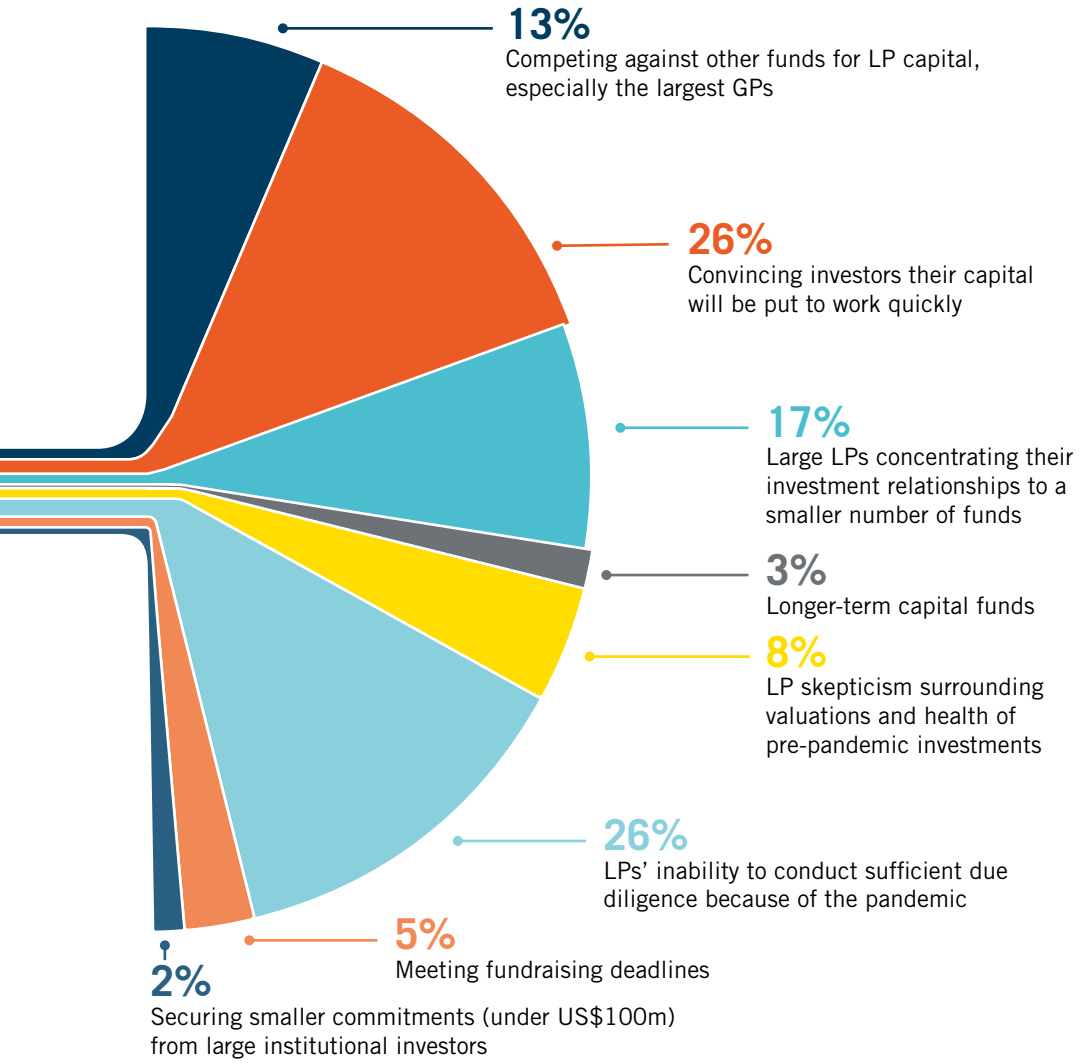
There is good reason to expect that full-year 2020, while below average compared against the heights reached in recent years, may not be so weak as widespread lockdowns and economic disruption might suggest. Only one in ten of our respondents expect fundraising will be negatively affected by suspensions related to COVID-19. Meanwhile, 61% of those surveyed said they raised a fund in the last 12 months or were currently raising a new fund—only slightly below last year's result of 67%.

"On the surface of it, one might expect travel bans to put fundraising on hold, but these processes are lifecycle driven," says Markus Bolsinger, a partner in Dechert's New York and Munich offices.

> "Fundraising has not changed, apart from the fact that the process now has a large virtual component, which had already been in the making for several years."
> Markus Bolsinger, Dechert

HAS YOUR FIRM RAISED A FUND IN THE LAST 12 MONTHS, OR IS IT CURRENTLY RAISING A NEW FUND?

IF YES, WHAT IS THE BIGGEST FUNDRAISING CHALLENGE YOUR FIRM HAS FACED? (SELECT THE MOST IMPORTANT)



"The large asset managers have been continuously fundraising for their many strategies and for them, fundraising has not changed, apart from the fact that the process now has a large virtual component, which had already been in the making for several years. Sponsors and limited partners have adjusted rapidly to the COVID-19 situation and this is a continuation of a pre-pandemic development."

As the pandemic continues to take a toll on the global economy—especially in sectors such as leisure, transportation and energy—certain assets will undoubtedly be held longer by their PE owners. In such cases, the GP may consider establishing a continuation vehicle.

A continuation fund allows GPs to transfer assets from the existing fund to a newly created vehicle—with LPs given the choice to exit or rollover into the new fund alongside new investors.

Fundraising for continuation vehicles poses unique challenges which managers must keep in mind: keeping the pricing attractive for a win-win-win situation for the GP, exiting LPs, and new investors can be a tough balancing act, requiring careful negotiation.

A time of opportunity

One element working in PE fundraising's favor is market timing. Fund vintages that immediately follow downturns generally outperform as there is a repricing opportunity for GPs to capitalize upon, as well as a rise in distressed deal flow. For this reason, funds raised in 2017 to 2018 that already had a majority of their capital drawn prior to COVID-19 are likely to be weaker performers. Those with capital to deploy since the pandemic struck, meanwhile, should deliver attractive returns over the next three- to five-year investment cycle. This puts well-capitalized managers at a significant advantage.

Some inertia in the fundraising market remains a possibility, however, as LPs pause and assess their portfolios and asset allocations. Stock market falls inherently overexpose investors to their illiquid assets by virtue of the denominator effect. However, 2020 has been unlike other down-markets. The fastest bear market on record has made the denominator effect short-lived. In principle, this should create a positive bias towards PE investment, although the sheer volatility of the stock market and the variance in sector performance will oblige LPs to take a measured approach to the PE strategy.

The complication of undertaking due diligence is another factor working against the fundraising market. Of the 61% of respondents who raised a fund in the last 12 months or are currently mid-raise, over a quarter (26%) believe that the most important fundraising challenge is LPs' inability to conduct sufficient due diligence because of the pandemic, due to social distancing measures and travel restrictions. This is matched by 26% who believe convincing investors their capital will be put to work quickly will be their biggest fundraising challenge in the current environment.

To some extent, a manager's success at fundraising depends on its investor base. Sponsors in the typically enviable position of having an institutional investor base are suddenly faced with the challenge of obtaining waivers and exceptions to on-site due diligence requirements, which is made more difficult when such requirements are set forth in statutes or regulations. Family offices, private foundations and high net worth individuals, on the other hand, are proving to be nimbler in this environment.

Firms with lasting investment relationships will be less affected. LPs are already familiar with the personnel of these firms, their strategies and investment styles. Therefore, the need for due diligence before re-upping into a successor fund is limited. Similarly, firms which are well known in the industry will be able to rely on returning investors as well as attract new investors, as their reputation in the market will make them a safer bet. It is the forging of new relationships that has been made more challenging by the inability to meet in person before committing to a new manager.

"The hardest challenge is for sponsors to truly connect with potential limited partners who they have never met and might not in the foreseeable future meet in person," says Bolsinger. "Fundraising has always been a high-touch process and not being able to share a meal, look someone in the eye and shake their hand is impacting the fundraising processes. But there's no alternative so people are doing it virtually."

These factors have been particularly accentuated with respect to first-time managers. Although some emerging managers have been able to raise their funds in the current environment, all of the typical disadvantages experienced by emerging managers have been magnified by virtue of the difficulties brought about through a compromised due diligence process.

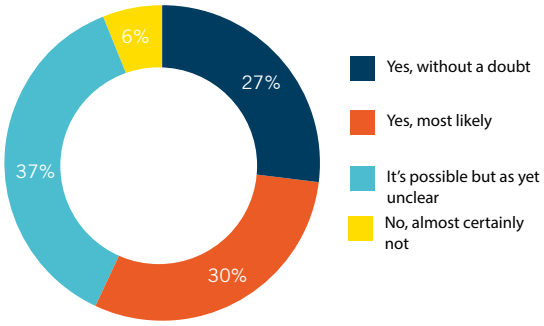
Beyond buyouts

A degree of competitive tension may have eased in 2020 as GPs momentarily turned their attention away from securing new deals and instead attended to their existing portfolio companies, providing both capital and operational knowhow. However, the fact remains that fund managers have more dry powder at their disposal than at any time in PE's history. This circa US$1.7 trillion stockpile means there continues to be pressure on firms to be creative.

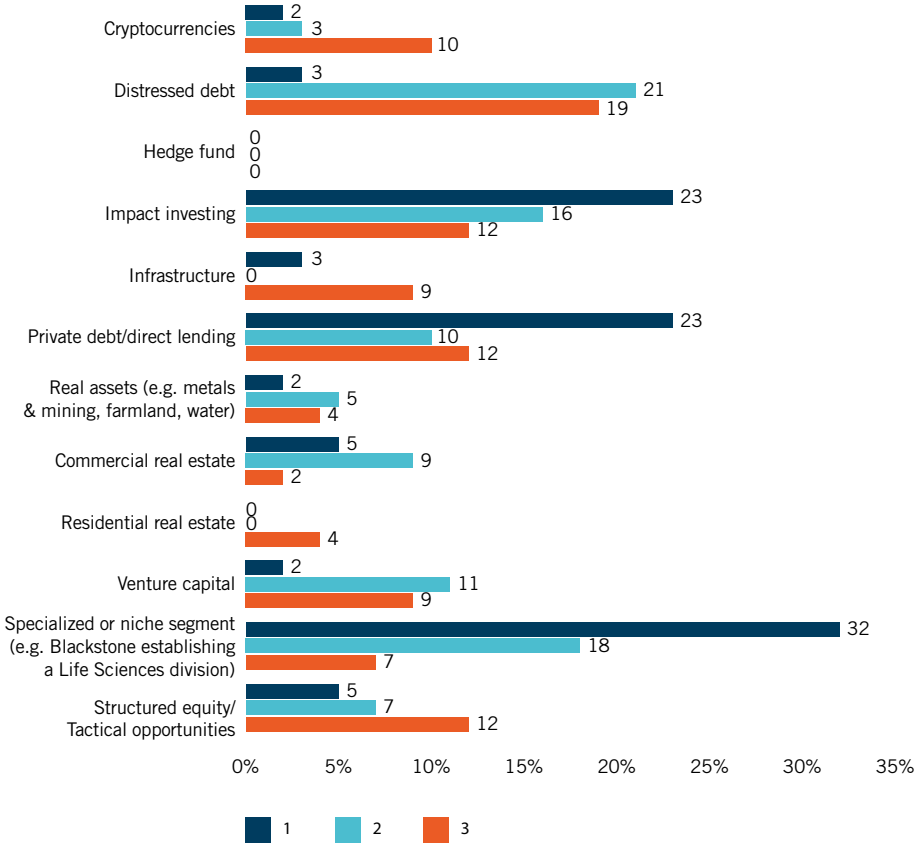
Further, an ongoing pre-pandemic trend is the concentration of capital. LPs' appetite for PE assets continues to grow, but even as they increase their exposure to the asset class, they have sought to rationalize the number of managers with whom they invest. This is benefiting large, multi-strategy outfits that are able to deliver diversified risk-adjusted returns via not only buyouts but the gamut of private capital asset classes, from growth equity to investment-grade credit, infrastructure to distressed debt.

Although the number of respondents to this year's survey who say they will diversify their asset class over the next 12–24 months is down compared to last

OVER THE NEXT 12–24 MONTHS, DO YOU PLAN TO DIVERSIFY YOUR ASSET CLASS EXPOSURE?



IF 'YES, WITHOUT A DOUBT' OR 'YES, MOST LIKELY', WHICH ASSET CLASSES IS YOUR FIRM CONSIDERING EXPANDING INTO? (SELECT TOP THREE AND RANK THEM 1-2-3, WHERE 1 IS THE HIGHEST PRIORITY)



year, a clear majority (57%) are still looking to diversify. This comprises 27% who will definitely do so and 30% who say they are likely to.

The motivation for diversifying assets could become less pressing as the pandemic brings down buyout multiples in certain industries. In recent years, the buyout market has become red hot and elevated levels of dry powder has pushed price multiples upwards. One of the attractions of asset diversification is being able to serve investors with different risk and return expectations as well as being able to invest at all levels of the capital structure. The asset classes with the highest priority, meanwhile, are specialized or niche segments (32%) followed by impact investing (23%) and private lending (23%). The latter of these is one area that has seen a large influx of GPs in recent years. The number of asset managers operating in private debt hit a new high of 1,764 last year, more than double the number only five years ago. For buyout shops who have come to rely on these funds as a major source of leveraged financing, the popularity of the asset class is a clear benefit.

As for the motivations behind pushing into adjacent asset classes, 29% of firms cited the advantages of becoming a larger-scale firm and 28% said pursuing higher returns/specific opportunities was the top reason for such a move.

WHAT IS THE MAIN REASON YOUR FIRM IS CONSIDERING EXPANSION INTO NEW ASSET CLASSES?

COVID-19 makes its mark

The most recent comparable crisis to the current pandemic is the GFC. However, they are also very different in nature. While 2008 was defined by a liquidity crunch in the banking system that had a knock-on effect on the economy, 2020 was primarily a health crisis that disrupted businesses and especially those in sectors dependent on physical interaction, such as hospitality, leisure, retail, and dining.

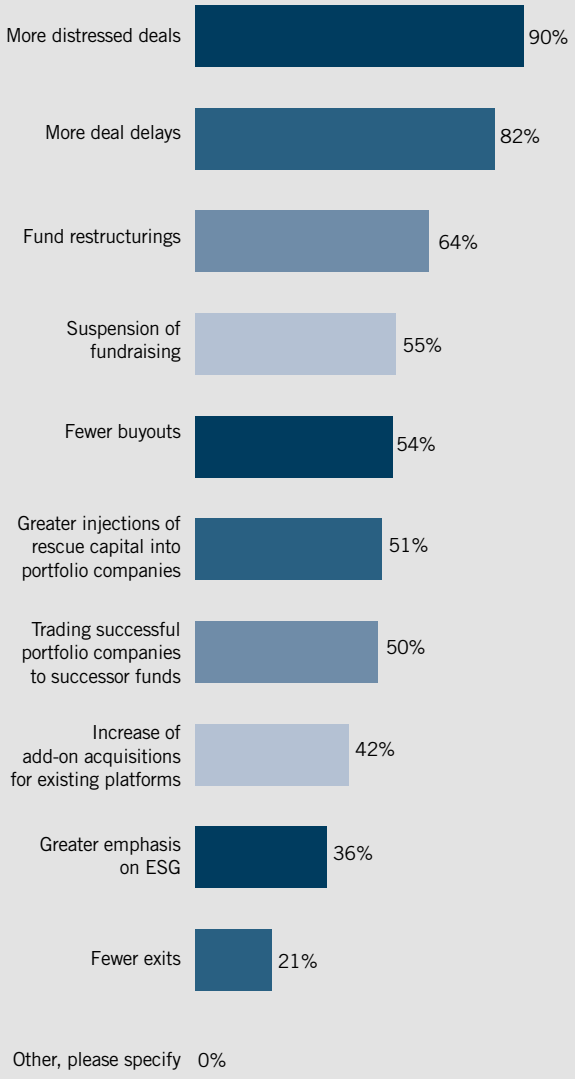
Their effects on the PE industry are likely to be divergent as well. In the short term, the liquidity crunch during the GFC made transacting nearly impossible, while in the longer term, the GFC resulted in a major regulatory push in the financial services industry in an attempt to reduce previously overlooked risks, although a decade of ultra-low interest rates have benefited the asset class. This policy drive made investment into PE funds by banks and insurers more onerous.

The effects of the current crisis on the PE industry are likely to be far less structural in nature. In the short term, the market and operational impacts to certain industries have been significant. Sectors such as energy, leisure and transportation, for instance, have seen buyout activity drop significantly in 2020. When surveyed in the summer, half (44%) of respondents believed the COVID-19 crisis would affect the PE industry more severely than the GFC, while a further 32% said it would affect the industry slightly more severely.

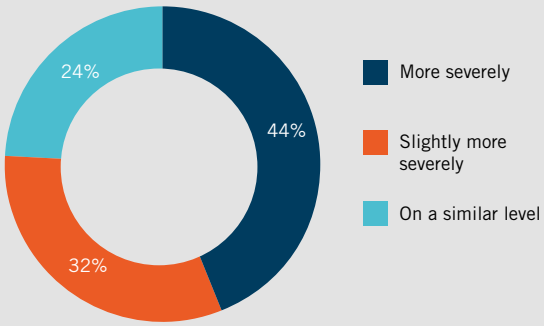
Longer term, the PE industry, however, is well-positioned to weather the storm brought about by the pandemic. Data from Q3 already shows bold strategies in effect, as deal values rose above the same quarter the previous year.

Nonetheless, the pandemic is still expected to bring about changes to society and the economy, and therefore to the PE industry. In terms of how these will manifest, respondents expect more distressed debt deals (90%) in the wake of the ongoing COVID-19 crisis. Continued travel restrictions and remote working could also lead to continued delays in

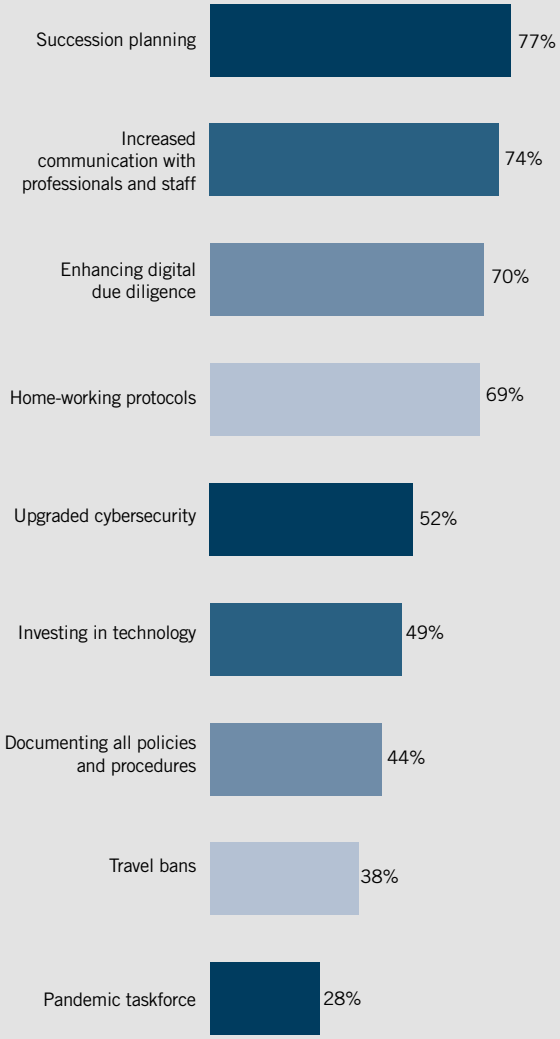
WHAT TRENDS DO YOU SEE GROWING IN THE WAKE OF THE ONGOING COVID-19 CRISIS (CHOOSE ALL THAT APPLY)?



HOW WILL THE COVID-19 CRISIS AFFECT THE INDUSTRY COMPARED WITH GREAT FINANCIAL CRISIS?



WHAT PLANS HAVE YOU PUT IN PLACE TO MAINTAIN BUSINESS CONTINUITY DURING THE ONGOING COVID-19 CRISIS? (CHOOSE ALL THAT APPLY)



deals (82%), although the uptick in deals announced in Q3 suggests that some transactions which were put on pause at the start of the pandemic are back on the table.

PE firms looking to put in place business continuity plans during the pandemic were split on the best way to do so: tasks that PE funds have been tackling are succession planning (77%) and increased communication with professionals and staff (74%), as well as the expected administrative protocols and procedural changes during the pandemic, such as home-working protocols (69%) and improved cybersecurity (52%). Surprisingly, only 28% established a pandemic task force.

LP trends: Co-investments

Co-investing, whereby LPs in a fund invest directly into deals alongside the fund, has gained in popularity in recent years. In keeping with our previous findings, the vast majority (74%) of firms report an increased appetite for co-invests and joint ventures among their LP clients over the past 12 to 24 months.

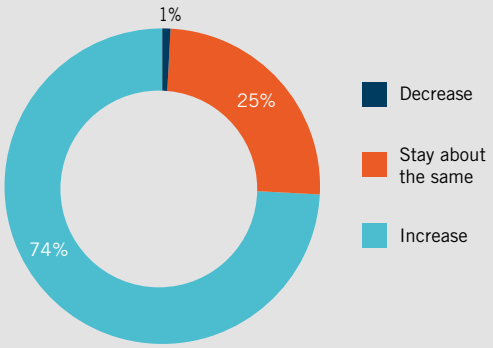
Since the GFC, co-investment capital nearly tripled to 28% of all capital committed to the PE asset class in 2019. This is perhaps unsurprisingly with deal sizes increasing—the number of deals worth US$10bn or more has steadily been increasing since 2015. Deals of that scale would be difficult to pull off without co-investments.

On the LP side, interest in co-investments has been driven in large part by a desire for more control, according to survey respondents. Nearly a third (30%) of GPs say that LPs are chiefly seeking greater control over the direction of their portfolio companies while 28% say it is to average down the cost of investing. Just under a quarter (22%) say it is so LPs can put more capital to work.

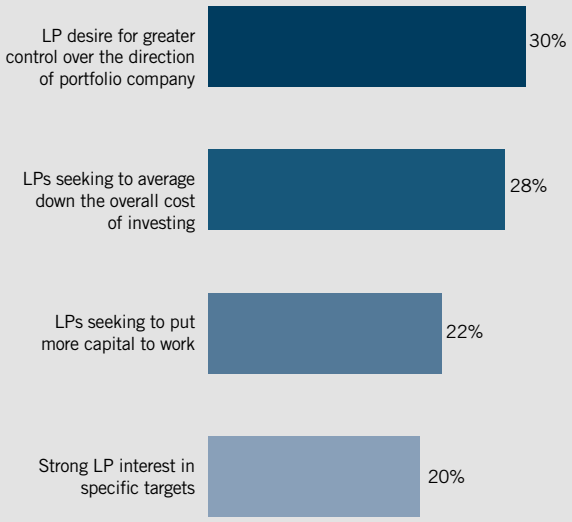
Respondents were least likely to say that LPs' interests in specific targets was the main motivation for co-invests (20%), although this result was double last year's (10%), suggesting that it is a growing trend.

Looking ahead, some of the largest LPs invested in PE have signaled intentions to commit to co-invests for the long term. The US$246bn California State Teachers' Retirement System, the second-biggest pension scheme in the US, has said it will continue to build out its co-investment team in spite of the pandemic.

OVER THE LAST 12–24 MONTHS, HOW HAS THE LEVEL OF INTEREST IN CO-INVESTMENT AND JOINT VENTURES ON THE PART OF YOUR LPS CHANGED, IF AT ALL?



IN YOUR EXPERIENCE, WHAT IS THE PRIMARY DRIVER OF LP INTEREST IN CO-INVESTMENT OR JVs CURRENTLY?



An open partnership

One of the more notable industry innovations that has grown in popularity is GPs selling a minority piece of their own management firms to third parties. This trend was best illustrated by the recent announcement that Mubadala Investment Company, a UAE-based sovereign wealth fund, had acquired a stake in US PE firm Silver Lake. As part of the deal, the PE house is launching a new long-term investment strategy with a 25-year time horizon—far longer than the typical 10-year PE fund lifespan.

This has been a gradually emerging trend but until recently has largely been the preserve of the very biggest multi-strategy institutional firms, many of which were founded decades ago and have sought solutions to their succession needs.

That is beginning to change as investment firms—often entities that would typically be classed as LPs—with limited in-house private markets expertise seek to acquire that knowhow rather than develop it organically. For their part, GPs can benefit from having a long-term strategic partner alongside them.

Among our respondents, 56% of GPs have not sold a minority stake in their firm over the last three years. Of those who have not brought outside investors into the management business, 37% are considering the possibility of selling a minority stake. Of those who did or are considering selling a minority stake, the main driver for this is succession planning (41%) followed by gaining access to growth capital for new lines of business (34%)—a change from last year's results, which found that gaining access to growth capital was the primary driver (45%), while succession planning was only cited by 30% of respondents as a driver.

Over the next few years this trend has the potential to become more mainstream, even among smaller managers and in non-buyout firms. In recent months, for instance, Japanese financial services group Daiwa took a 40% stake in German renewables fund manager Aquila Capital.

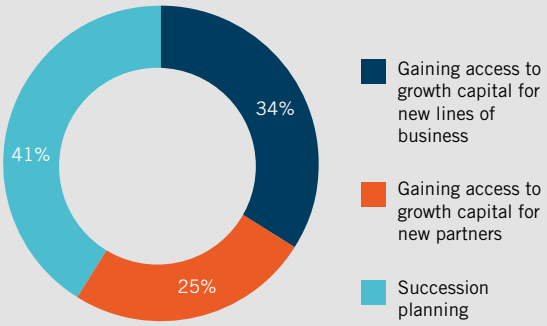
Despite some downsides, including potential skepticism from the existing LP base, this trend could be boosted if the exit environment becomes more challenging and fund managers seek alternative sources of capital in order to meet the GP commitments to their own funds. If fund managers are not able to realize sufficient capital from the portfolios they manage, outside parties represent a credible substitute and may be capable of negotiating attractive buying terms depending on the scarcity of liquidity available to GPs from portfolio company sales.

On the other hand, for many GPs selling an interest in their management firm, this is an opportunity to monetize the intangible value they have built over years of hard work. However, if COVID-19 has a negative impact on incentive allocations, GPs may not consider it an opportune time to sell and may prefer to wait until the value of their firm returns to normal.

OVER THE PAST THREE YEARS, HAS YOUR FIRM SOLD A MINORITY STAKE IN THE GP/FIRM?

IF NO, IS YOUR FIRM CONSIDERING THE POSSIBILITY OF SELLING A MINORITY STAKE?

IF YES, WHAT IS OR WAS THE MAIN DRIVER OF SELLING A MINORITY STAKE IN THE FIRM?



Spotlight on APAC

The three major PE jurisdictions—North America, EMEA and APAC—have seen their deal activity impacted to different degrees by the pandemic. This correlates with varying responses to the health crisis.

The first three quarters of 2020 saw US$80.5bn in buyout deal activity in the APAC region, an impressive 13% rise above the same period in 2019. Volume over this period fell 8% to 379 deals—a far less steep drop than overall PE volumes. The top sector by a considerable distance was TMT with US$33bn invested, followed by pharma, medical and biotech with US$13.4bn invested.

These deal totals set the region's PE market apart as the least affected by the ongoing crisis. A number of countries in the region are considered as having capably contained the virus outbreak, including China, South Korea, Taiwan, Hong Kong, Singapore, Vietnam, Thailand, Japan and Australia.

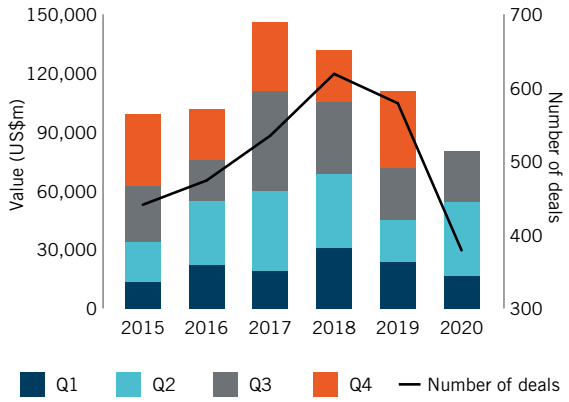
"In certain industries, the pandemic is still having a large impact, but by and large, in Asia, COVID-19 is quite contained and well dealt with. In many countries in the region, people are more or less going about their lives as normal and restrictions are loosening," Siew Kam Boon, a partner in Dechert's Singapore office, says.

Unlike the US, for example, these countries imposed strict lockdown measures, track and trace approaches and mask-wearing to curb the virus. China, the world's second-largest economy and responsible for around half of the region's buyout value, had one of the most effective outbreak containment responses. Unlike APAC's other major economies, China is not expected to fall into recession in 2020, albeit the IMF prediction of 1.9% growth will be far and away the weakest expansion in decades.

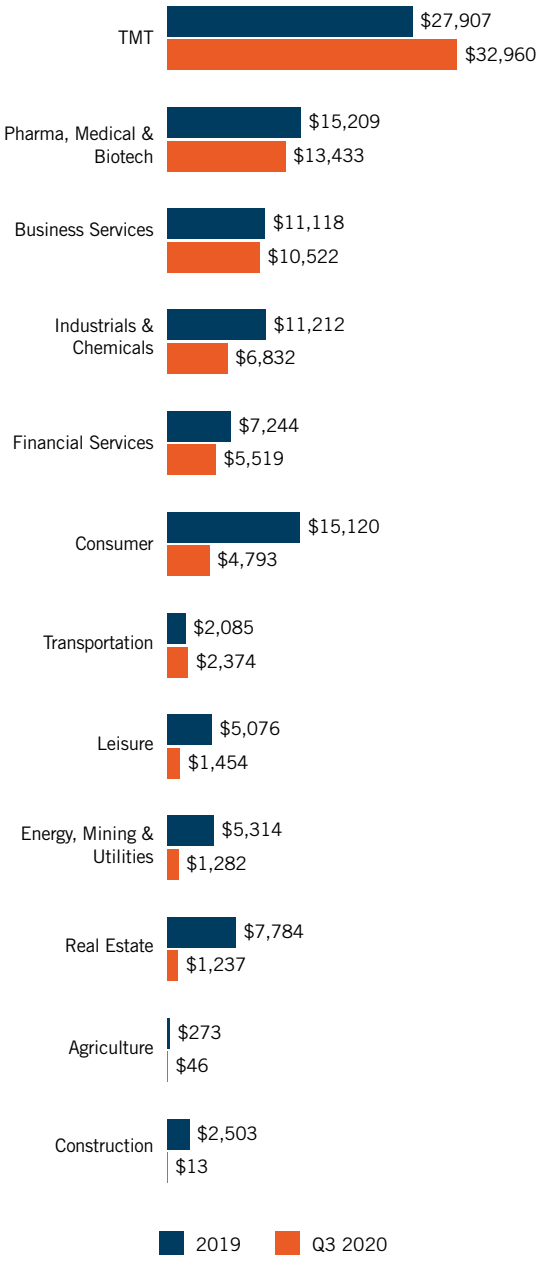
"From a macro perspective, conditions vary from jurisdiction to jurisdiction and the rules within each jurisdiction as to how they treat the COVID-19 crisis has varied," says Ross Allardice, a partner in Dechert's London office. "We seem to be seeing the effects of that in the private markets as the crisis has affected the way people have been able to conduct business."

Consistent with this more effective curbing of the health crisis in the region, APAC respondents are marginally less concerned by the effects of COVID-19 on the PE market than PE

NUMBER AND VALUE (IN US$BN) OF PE BUYOUT DEALS IN APAC, 2015 – Q3 2020



PE BUYOUT VALUE BY SECTOR IN APAC (US$M), 2019–2020

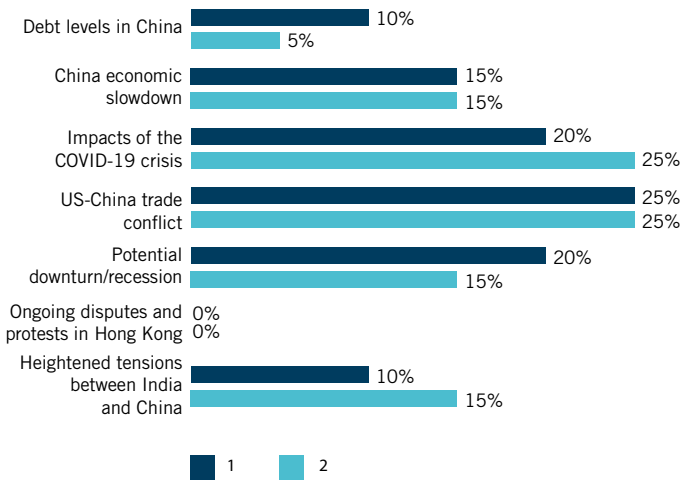


executives in other regions. Rather, their biggest concern is Sino-American diplomatic relations, which are at their worst in a generation. Half said the ongoing US–China trade conflict is the current development expected to have the biggest detrimental effect on dealmaking over the next 12–18 months. Just behind this, 45% of APAC respondents expect the COVID-19 crisis to have the largest impact on the deal environment.

The two are not unrelated. Last year, the trade war loomed large, but this has not abated. Instead, the US and Europe are taking an increasingly arms'-length approach to China, APAC's geopolitical and economic locus. This widening geopolitical chasm and economic decoupling from China have the potential to frustrate PE activity in certain industries and cross-border dealmaking in particular.

These tensions are being felt intra-regionally too. Both India and Japan introduced tighter restrictions on foreign investment in 2020, the latter cutting the threshold requiring foreign investors to notify regulators prior to share purchases in sensitive companies from 10% to just 1%.

IN YOUR ESTIMATION, WHICH CURRENT OR UPCOMING DEVELOPMENTS IN ASIA-PACIFIC WILL HAVE THE BIGGEST EFFECT ON THE DEAL ENVIRONMENT OVER THE COMING 12–18 MONTHS? (RANK THE TOP TWO 1-2, WHERE 1 IS MOST IMPORTANT)



> "In certain industries, the pandemic is still having a large impact, but by and large, in Asia, COVID-19 is quite contained and well dealt with."
>
> Siew Kam Boon, Dechert

"There are various dimensions to current geopolitical tensions beyond just the trade war between China and the US," says Boon. "Depending on the jurisdiction of the acquirer and the target as well as the industry the target is engaged in, certain cross-border deals are taking longer within the region because of these frictions. India, Japan and Australia have imposed new foreign investment rules and certain others within the region have developed informal policies along similar veins. Factory production is being repatriated by Japan and India or moved out of China into Southeast Asia."

The ongoing geopolitical tensions could accelerate a growing trend of the past few years: the increasing foreign direct investment (FDI) in Southeast Asia, as well as growth in the region's manufacturing sector.

Diplomatic challenges notwithstanding, APAC represents a huge opportunity for the PE industry. For one, it is the world's fastest-growing region, propelled by demographic tailwinds and a growing consumer class. In 2020, Asia's GDP is expected to overtake the GDP of the rest of the world combined and by 2030 will contribute 60% of global growth, according to the World Economic Forum.

APAC will also be responsible for around 90% of the 2.4 billion members of the middle class underpinning future demand. This will largely come from China, India and Southeast Asia's high-growth developing markets.

Not only does APAC have an unmatched economic profile—both in size and growth—it is significantly under-penetrated by PE. APAC currently represents just 25% of the global PE industry. This leaves headroom and runway for significant growth for the next decade at least. These fundamentals will ensure that PE investors remain compelled by the APAC growth story, in spite of current geopolitical tensions.

Deal targeting: No stone unturned

Unsurprisingly, the onset of the COVID-19 pandemic at the end of Q1 precipitated a sharp tumble in PE dealmaking, but activity has already rebounded significantly in Q3.

Globally, there were 1,510 transactions worth an aggregate US$234.7bn across the first six months of the year, a 19% drop in volume and a 22% drop in value on the same period in 2019. Q3, however, witnessed 750 deals worth US$148.1bn, representing a 10% rise in value, although volume was down 21% on Q3 2019.

"GPs spent much of March through to June in 2020 in crisis management of their portfolios, making sure their businesses had sufficient capital, because people were initially fearing a potential capital crunch," said Bolsinger. "However, once they put their houses in order and ensured that their portfolios were on a firm footing, things have returned to some degree of normality, especially on the transaction side. Funds are looking at buying and selling again. There was a shock, but it appears to have been relatively short-lived."

In spite of the rise in buyout activity in Q3, certain challenges for the industry remain as the global economy faces difficult conditions amidst a second wave of infections in parts of the world and subsequent social distancing measures.

Sales processes could take longer to complete, for one. Just over half (51%) of respondents said that their most recent leveraged buyout was done via a traditional auction process, and 55% said that the process took longer during the COVID-19 outbreak; 22% said it took substantially longer.

WAS YOUR MOST RECENT PRIMARY LEVERAGED BUYOUT VIA AN AUCTION PROCESS?

Another potential challenge is achieving adequate due diligence on assets. Analyzing profit and loss accounts and balance sheets is only one part of the diligence equation. Flying to meet senior management teams has been frustrated by lockdowns and a greater aversion to in-person meetings. While videoconferencing tools have helped to keep business processes—and indeed the

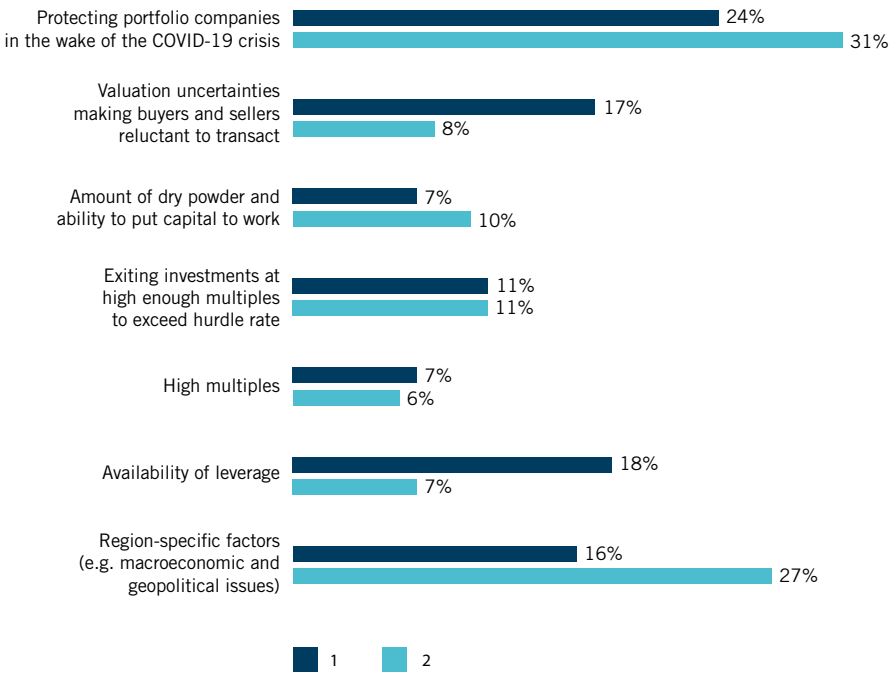
global economy—in motion, they are a meager, though unavoidable, substitute for sitting across the table from a senior management team and being able to read the room.

Another issue is the simple challenge of agreeing on price. Businesses largely unaffected or even buoyed by COVID-19 continue to demand elevated evaluations. However, businesses that have been affected are faced with a pandemic discount and the task to pro-forma adjust their financials for the COVID-19 disruption. Those are the transactions for which bridging the gap between the seller's expectations and the buyer's assessment of value can be a challenge, especially where the long-term impact of current events on the business model and earnings of a company is open to interpretation.

One way to address the gap between seller expectation and buyer assessment is the inclusion of earn-out provisions. These are of particular relevance in light of current economic and trading conditions and can help buyers and sellers to get a deal over the finish line.

"We have seen more earn-outs to bridge the total valuation gap," said Bolsinger. "It can be difficult at times like this for parties to agree on price and earn-outs help to give buyers peace of mind and reward sellers who are true to their word on the prospects of the businesses they are selling."

WHAT DO YOU SEE AS THE BIGGEST CHALLENGES CURRENTLY FACING THE PRIVATE EQUITY INDUSTRY?



While valuation uncertainties which make buyers and sellers unwilling to transact were cited by 17% of respondents as the greatest challenge to the PE industry, managing existing assets pose a bigger concern. Indeed, 31% ranked protecting portfolio companies in the wake of the crisis as the biggest challenge to the industry—and 24% cited it as the second-greatest challenge.

> "It can be difficult at times like this for parties to agree on price and earn-outs help to give buyers peace of mind."
>
> Markus Bolsinger, Dechert

Closing the deal

Once a price has been agreed to, much can still go wrong before the deal is completed. This is where material adverse change (MAC) clauses come in. A MAC clause gives the buyer the right to walk away from a deal should events drastically change after the deal has been agreed but before it has closed.

Historically, these clauses have been necessarily broad as they are intended to address circumstances that are not known at the time of the negotiation. In 2020, they have been brought into sharper focus in light of market turbulence.

Given the downturn in the economy and the unpredictability of the recovery, MAC clauses will continue to be subject to greater scrutiny in deals going forward—M&A practitioners will be running a fine-tooth comb over their precise definition to avoid being unexpectedly on the hook. Three-quarters (75%) of all respondents have seen a significant change in the negotiation and/or wording of what constitutes a MAC.

Moreover, as a result of the pandemic, the inclusion of MAC clauses in merger agreements could expand in regions where they are not as commonly used. The vast majority of respondents in EMEA (86%) and APAC (75%)—where MAC clauses have historically been rarer than in North America—say they have seen an increase in their usage in their jurisdictions.

Nonetheless, the increasing usage of MAC clauses and the greater attention paid to their negotiation should not be seen as a major obstacle to dealmaking. MAC clauses are typically not a central negotiating point in APAC transactions, said Boon. "Parties usually reserve their negotiation capital for other things. But this year, MAC clauses have been a focus, particularly if the transaction completion date is stretched out," she added.

Mitigating exposure

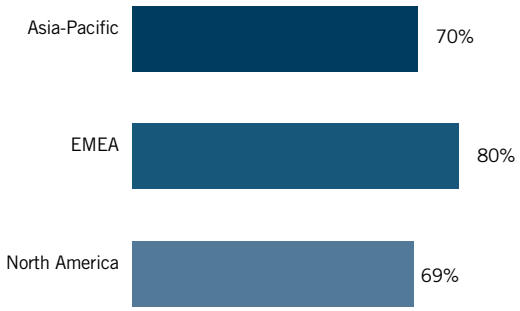
In keeping with a more unpredictable market, respondents across all regions (80% in EMEA, 70% in APAC and 69% in North America) have seen an increase in M&A insurance (representation and warranty insurance in North America and warranty and indemnity insurance in EMEA and APAC) being used in transactions.

"The market is still red hot for warranties and indemnities insurance in APAC and EMEA," said Boon and Allardice. "And the same is true for representation and warranty insurance in North America."

HAVE YOU SEEN A SIGNIFICANT CHANGE IN THE NEGOTIATION AND/OR WORDING OF WHAT CONSTITUTES A MAC (MATERIAL ADVERSE CHANGE)?

HAVE YOU SEEN AN INCREASE IN THE USE OF MAC (MATERIAL ADVERSE CHANGE) CLAUSES IN YOUR JURISDICTION? (YES ONLY)

HAVE YOU SEEN AN INCREASE IN WARRANTY AND INDEMNITY INSURANCE BEING USED? (YES ONLY)



The use of M&A insurance can help sellers to transfer indemnity-risk to insurance providers in order to protect themselves against having to return proceeds to the buyer for losses after the deal has closed.

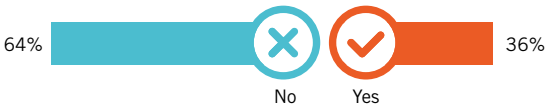
Taking a smaller piece

Private equity is typically associated with the acquisition of majority positions in companies via leveraged buyouts, and management teams retaining a minority stake to ensure their interests are aligned with the GP. Although this established model continues to constitute the majority of PE investment activity, 98% of firms surveyed said their firms made minority investments.

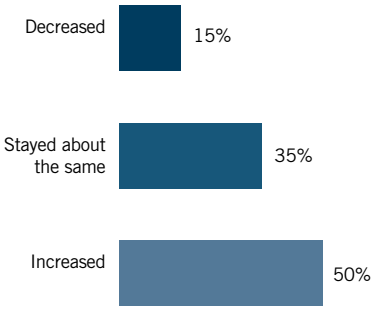
There is potential for this investment type to increase over the next 12 to 24 months in light of current circumstances. For one, owners who might not have previously been willing to accept PE investments are more likely to seek financing options as earnings come under pressure. Even in a benign economic environment, minority deals have the advantage of allowing the current owners to retain control over their business. The minority alternative is comparatively more appealing.

DOES YOUR FIRM MAKE MINORITY STAKE INVESTMENTS?

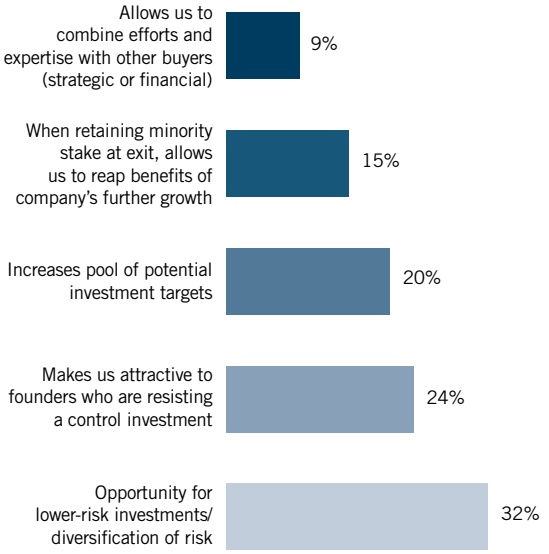
DOES YOUR FIRM EVER RETAIN A MINORITY STAKE WHEN EXITING A PORTFOLIO COMPANY?



IF YES, OVER THE LAST 12–24 MONTHS, HOW HAS YOUR FIRM'S TARGETING OF MINORITY STAKE INVESTMENTS (OR THE RETAINING OF A MINORITY STAKE WHEN EXITING A PORTFOLIO COMPANY) CHANGED, IF AT ALL?



IF YES, WHAT IS THE MOST IMPORTANT DRIVER OF MINORITY STAKE PURCHASES OR RETENTIONS BY YOUR FIRM?



For GPs, the flexibility to make a minority investment can increase the likelihood of securing a deal and a meaningful foothold in an attractive asset at a favorable valuation, since sellers are not risking selling most of their equity at a bargain price.

Another related trend of recent years has been for GPs to retain a minority stake when exiting a portfolio company. This has the benefits of giving the selling fund exposure to future upside in a company and a management team they know and believe in. While rolling over a portion of its investment in connection with a sale is less popular than minority investing, it is still employed by a clear majority of GPs where it makes sense to do so—64% of firms reported conducting these minority position retentions.

Of those firms who participate in minority stake acquisitions or minority rollovers, 50% have increased this activity over the last two years while 35% have maintained levels. Nearly a third (32%) stated that the most important driver of these deals is the opportunity for lower-risk investments or to diversify their risk, followed by 24% who said such arrangements are attractive to founders who are resisting a control investment.

One of the potential complications of this trend is putting in place M&A insurance when the GP is exiting ahead of the majority shareholder. Insurers can sometimes be hesitant to underwrite risk for a minority investor who does not have operational control—this is something GPs will have to bear in mind as these deals become more commonplace.

Getting creative

PE firms remain equipped with capital commitments, the volume of which they have never previously seen. Although the buyout market saw a sharp quarter-on-quarter rise in Q3, many industrials are still facing challenging conditions which have put their valuations under pressure. In such cases, GPs will be incentivized to get creative with their deal structures and find mutually attractive deals in order to compel owners who may be reluctant to sell unless they have to.

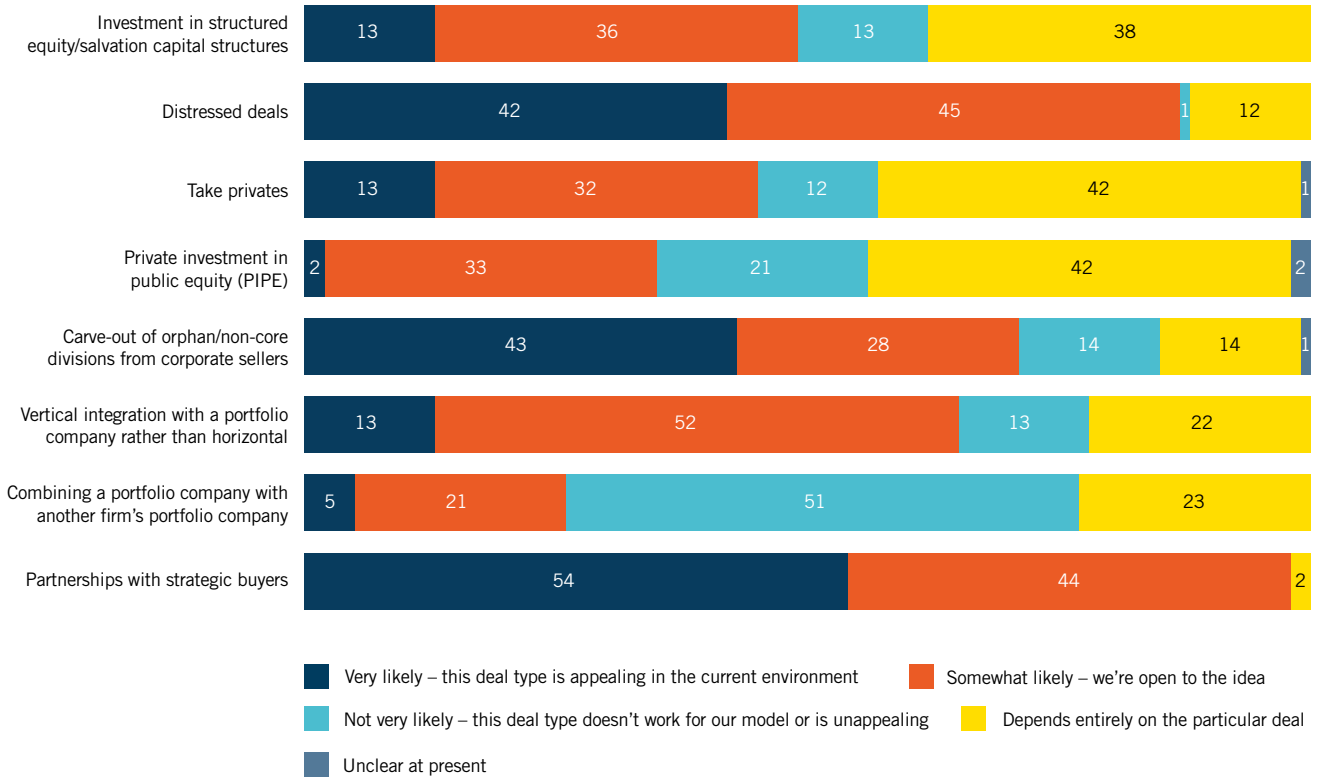
In addition to eyeing carve-outs and minority stake opportunities, firms are more likely to weigh up strategic alignments with corporates and companies that have come under stress amid the pandemic. Nearly all (98%) of respondents at present are likely—and 54% very likely—to consider partnerships with strategic buyers.

The benefits of such partnerships are two-fold. The GP gains tacit sector knowhow which can help to deliver higher-value gains and de-risk the investment. It also gives the GP a potentially effortless exit route as the strategic will often have a prearranged call option or similar arrangement on the asset and will already know it intimately.

Distressed deals are another deal type that is being widely considered—as much as 87% of firms are currently weighing such transactions. It goes without saying that business defaults will be elevated through 2020 and likely 2021, especially in sectors hit hard by the pandemic. This will present an opening for opportunists and distressed debt funds in particular, which can acquire debt for a fraction on the dollar and force equity swaps.

Other provisions that may become more popular are structured equity investments with varying levels of seniority and convertible or exchangeable options, as well as tranche provisions that allow GPs to make follow-on investments, provided that agreed performance milestones are reached. These are especially attractive in the current environment. These structured equity investments can take the form of equity or debt and can help to give GPs greater security, limiting their downside risk, while staggering follow-on investments in tranches can ensure funds increase their exposure to a business only when it proves that it can perform in challenging economic conditions. The bottom line is that creativity and flexibility in deal structuring can improve the chances of deals closing as the buy-side and sell-side make concessions.

HOW LIKELY IS YOUR FIRM TO CONSIDER THE FOLLOWING DEAL TYPES AT PRESENT? (SELECT ONE FOR EACH TYPE)



Buy-and-build

Roll-up strategies are one of PE's ways of creating value—GPs can outsize their returns by buying a platform company, bolting numerous companies on to it and selling the enlarged entity.

The strategy also tends to be more attractive in the recessionary environment. Buy-and-build transactions are one of the few forms of M&A which have increased in number throughout 2020. There were 1,249 such transactions in the first three quarters of the year, a 28% increase YOY, although the size of these deals has been smaller—despite the rise in volume, total value of such transactions dropped 29% over the same period to US$32bn.

The reason this strategy is so compelling is that there is often an arbitrage opportunity. Smaller companies generally trade at lower earnings multiples than larger businesses and there is less competition for these assets as they can fly under investors' deal sourcing radars. GPs not only benefit from building a bigger and better asset, they can compound their return by coming in at a lower entry multiple and exiting at a higher multiple.

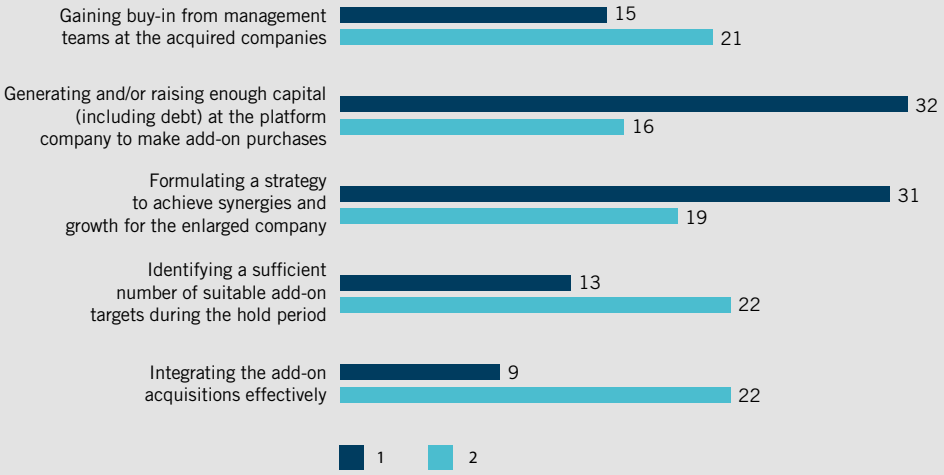
"Add-on acquisitions present a lower risk than acquisitions of a new platform, since the GP already is invested in the industry," Bolsinger stated. "In addition, these deals are often proprietarily sourced, using management's and the GP's existing contacts with and knowledge of the other market participants."

This is a tried-and-tested method. More than two-thirds (68%) of firms use buy-and-builds at any of their portfolio companies and, of those, around one-third (34%) of their portfolio companies pursue the strategy.

As earnings come under pressure, the synergistic cost savings that can be achieved through clubbing assets together will continue to make buy-and-builds more compelling. Moreover, given that the exit environment is likely to prove more

DOES YOUR FIRM USE THE BUY-AND-BUILD STRATEGY (DEFINED AS TARGETING ADD-ON ACQUISITIONS TO A PLATFORM COMPANY OVER THE COURSE OF A HOLD PERIOD) AT ANY OF ITS PORTFOLIO COMPANIES?

IF YES, WHAT ARE THE BIGGEST CHALLENGES YOUR FIRM FACES WHEN MAKING ADD-ON ACQUISITIONS FOR A PLATFORM COMPANY? (SELECT TOP TWO AND RANK THEM 1-2, WHERE 1 IS MOST IMPORTANT)



challenging, rather than bringing assets to market, GPs may spend more time developing their existing assets through add-ons and put the new and improved business up for sale when market conditions have stabilized.

Tech synergies

Technology is also taking a central role, whereby add-on acquisitions can harness the tech assets of the platform, providing a further synergistic dimension to build-outs. For 29% of firms, the first-choice investment thesis for a buy-and-build is building a platform company around a core technology. The second most favored strategy, cited by 31% of respondents, is building a dominant player in an emerging sector, benefiting from the early-mover advantage.

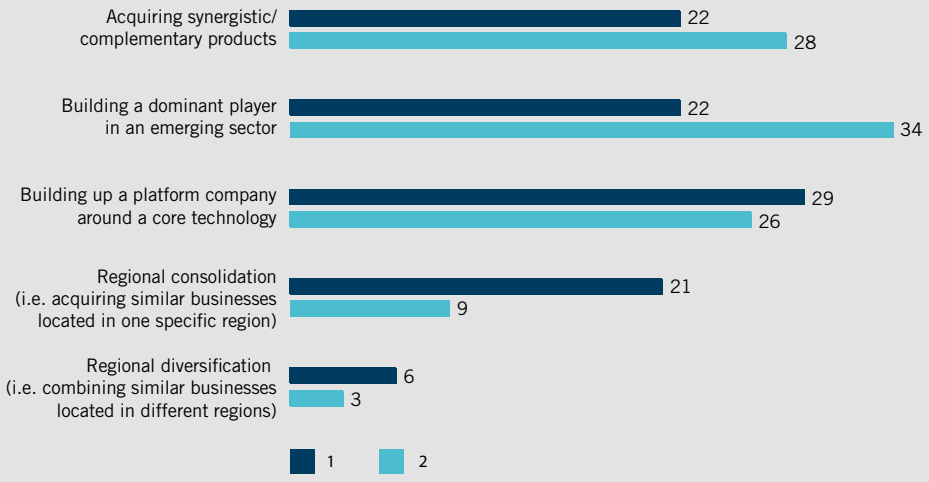
It is perhaps unsurprising, then, that add-on investments have proved exceptionally popular in the TMT sector this year. The total value of such deals reached US$12.9bn in the first three quarters of the year, more than four times the total value over the same period the year before.

Challenges remain

For all the benefits of scaling up a platform business, buy-and-builds are not without their challenges. For one, there are financing demands that may not be able to be met by the PE fund itself over concerns of concentrating too much capital into one portfolio company. This requires debt financing and 32% of GPs that use this strategy say that generating and/or raising enough capital (including debt) at the platform company to make add-on purchases was their biggest challenge. This is closely followed by 31% who say that formulating a strategy to achieve synergies and growth for the enlarged company is their greatest concern.

"The biggest challenge has been the complexity of executing these," said Boon. "The key problem is first identifying targets that can be synergistic and then fulfilling the requirements of achieving those synergies. The execution of these deals is fairly complex in Asia, particularly with its diverse rules around foreign ownership restrictions, regulatory approvals, exchange controls and stakeholder interests, among others. So, GPs need to think carefully before executing these strategies."

IF YES, WHICH BUY-AND-BUILD STRATEGIES DO YOU CURRENTLY USE MOST OFTEN? (SELECT TOP TWO AND RANK THEM 1-2, WHERE 1 IN MOST COMMON)

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Carve-outs

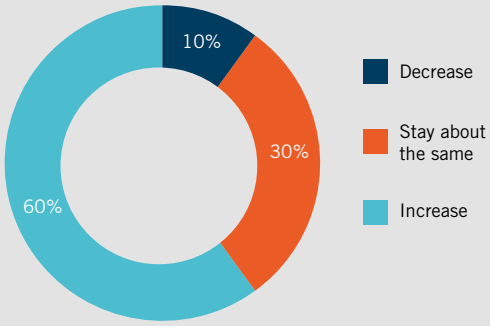
Acquisitions of corporate assets can be expected to rise, not in spite of the coronavirus pandemic but because of it. After more than a decade of accumulating debt in the low-rate environment precipitated by the GFC, corporate liabilities are at an all-time high. The amount of global debt from financial and non-financial corporates rated by S&P Global Ratings topped US$20.6 trillion in 2020. As earnings come under pressure amid the economic fallout of the health crisis, this could tip some large businesses into default territory.

An attractive option for corporates seeking to deleverage their balance sheets is to review their operations to identify any non-core business units that can be divested. Well over half (60%) of respondents in our research expect to increase the number of carve-outs targeted by their firm over the next 12-18 months; further, corporates' need to pay down debt is seen by 33% of GPs as the most important current driver for this activity over the next few years.

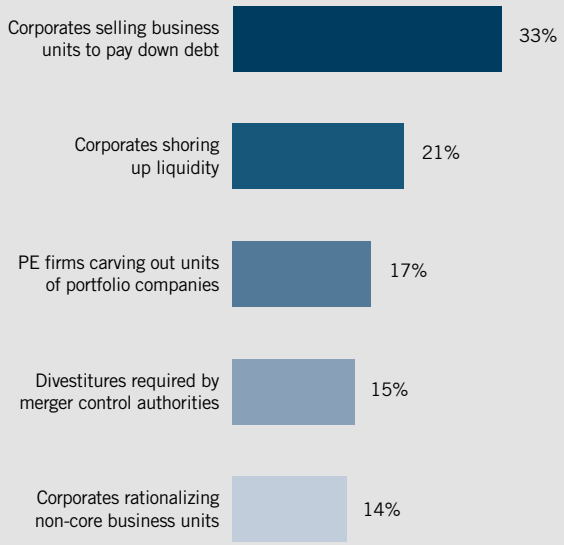
"Conglomerates that are over-leveraged and have collateralized heavily against their assets have been looking at divesting their assets to delever as well as to conserve liquidity for existing assets. That's happening more and more, particularly because of the COVID-19 situation," said Boon.

Of course, PE houses themselves may utilize carve-outs as a strategy for their own assets—indeed, 17% of firms said they anticipate carving out units of portfolio companies. This may come as existing portfolio businesses come under pressure and GPs seek ways to drum up cash, but going forward, fund managers are also likely to scrutinize new deals more carefully over the coming months for opportunities to streamline assets by selling off superfluous units in the target business.

OVER THE NEXT 12-18 MONTHS, WHAT DO YOU EXPECT TO HAPPEN TO THE NUMBER OF CARVE-OUTS TARGETED BY YOUR FIRM?



IN YOUR OPINION, WHAT IS THE MOST IMPORTANT CURRENT DRIVER OF CARVE-OUT ACTIVITY?



Spotlight on North America

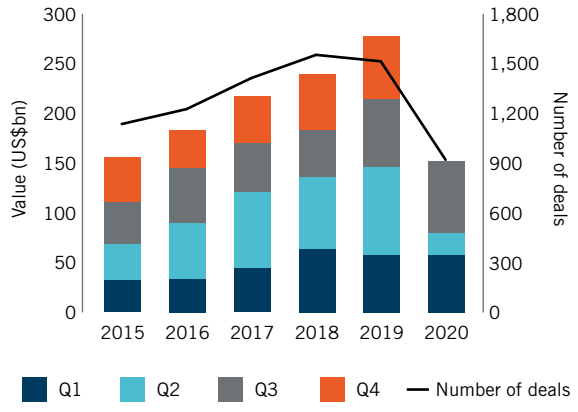
In the first three quarters of 2020, North America saw 921 PE buyouts, worth US$151.4bn in total—a 23% decrease in volume and a 29% decrease in value compared to the same period in 2019. This is a steeper fall than either the APAC or EMEA regions—likely a reflection of the high number of COVID-19 cases in the region. Nonetheless, Q3 has seen a sharp rise in buyout activity on the previous quarter, with value increasing by 229% to US$71.9bn, while volume rose 16% to 281 deals.

Bigger deals also appear to already be making a comeback, with 19 US$1bn-plus buyouts announced in the region in Q3, more than in all of the first half combined and in Q3 of the previous year.

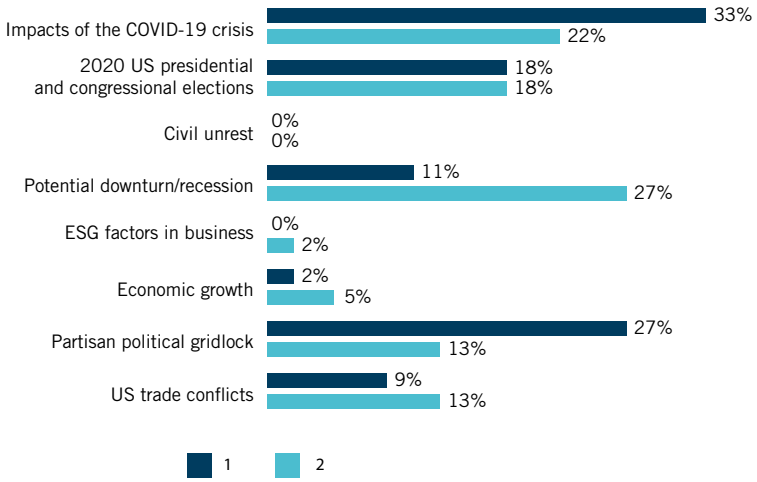
The top sector across the first three quarters was TMT with US$59.7bn in total deal value. This in part speaks to the broad reach of this sector, covering as it does technology, media and telecoms. But the strong showing of TMT also reflects the prospects of technology and software businesses. The pandemic has revealed weaknesses in business models that flourished in pre-lockdown times but have been stopped in their tracks in 2020, with traditional retail, leisure and hospitality in particular exposing their vulnerabilities. Conversely, many tech and software businesses have not only withstood the effects of lockdown but boomed as a consequence, as consumers and businesses came to depend upon their products and services amid lockdown conditions and remote working.

One-third (33%) of North

NUMBER AND VALUE (IN US$BN) OF PE BUYOUT DEALS IN NORTH AMERICA, 2015 – Q3 2020



IN YOUR ESTIMATION, WHICH CURRENT OR UPCOMING DEVELOPMENTS IN NORTH AMERICA WILL HAVE THE BIGGEST EFFECT ON THE DEAL ENVIRONMENT OVER THE COMING 12-18 MONTHS?



American respondents point to the impacts of the COVID-19 crisis as the development that will have the biggest effect on the deal environment in the next 12-18 months. A further 22% chose this as the second most important effect on deal conditions.

However, politics are also playing on the minds of North American GPs. Partisan political gridlock was seen as another major concern, with 27% of respondents choosing it as having the biggest effect on dealmaking.

Q3 has seen a sharp rise in buyout activity on the previous quarter, with value increasing by 229% to US$71.9bn, while volume rose 16% to 281 deals.

Worries about the result of the 2020 election also had an impact on the M&A community. The months leading up to the presidential election in November sent GPs to the negotiating table to explore what price they could potentially achieve for selected assets. This was motivated by the possibility that a Democratic presidential administration and Congress would attempt to legislate for tax hikes.

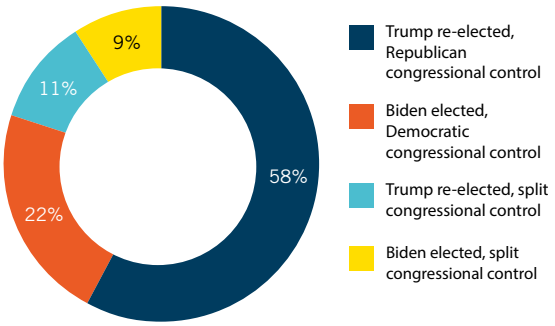
"Not just higher taxes on the corporate side, but higher taxes on capital gains are a real possibility. Investment banks have spent Q2 and Q3 calling clients to see whether they have anything to sell," said Bolsinger. "If any company was semi-ripe for exit, GPs have pursued an exit and, depending on what indications of value they received and what they expect the tax environment to be, decided whether or not to press ahead with a sale."

Surveyed before the election, a majority of North American respondents (58%) said an election resulting in President Trump's reelection and Republican control of Congress would have the most positive impact on the PE market. Meanwhile, an election that would see Joe Biden elected president and the Democratic Party take over Congress was seen by 42% as the outcome that would have the most negative impact on the industry—far more than any other potential outcome.

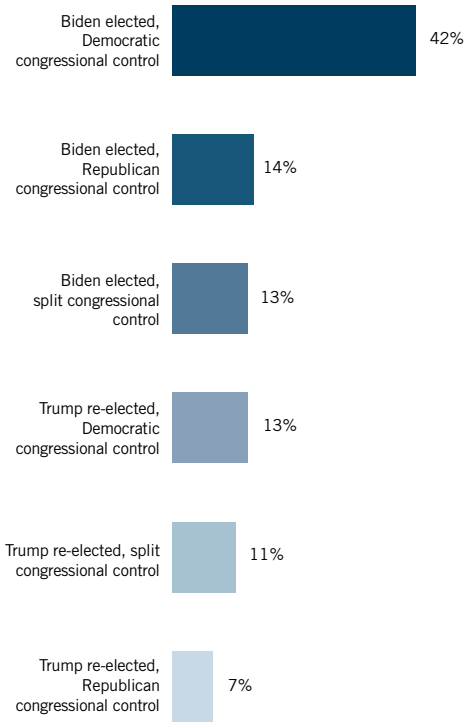
Looking towards 2021 and further ahead, there is good reason to expect a significant rebound in North American buyout value. As the biggest M&A market in the world and home to the world's largest transactions, it stands to reason that North America would experience the steepest decline in deal value in 2020. As corporates and PE funds acclimate to current economic conditions, this should result in a return to the negotiating table. This recovery has already begun in Q3, observed in the quarterly jump in deal activity and in larger deals.

Although Joe Biden's election as president and the Democratic Party's retention of their majority in the House of Representatives was not the preferred outcomes for respondents, a clear electoral result will be a relief to dealmakers. Moreover, while Biden plans to increase the corporate tax rate, tax impact is not usually the deciding factor in an M&A deal. Although some buyers may be dissuaded from deals, deal activity is set to continue.

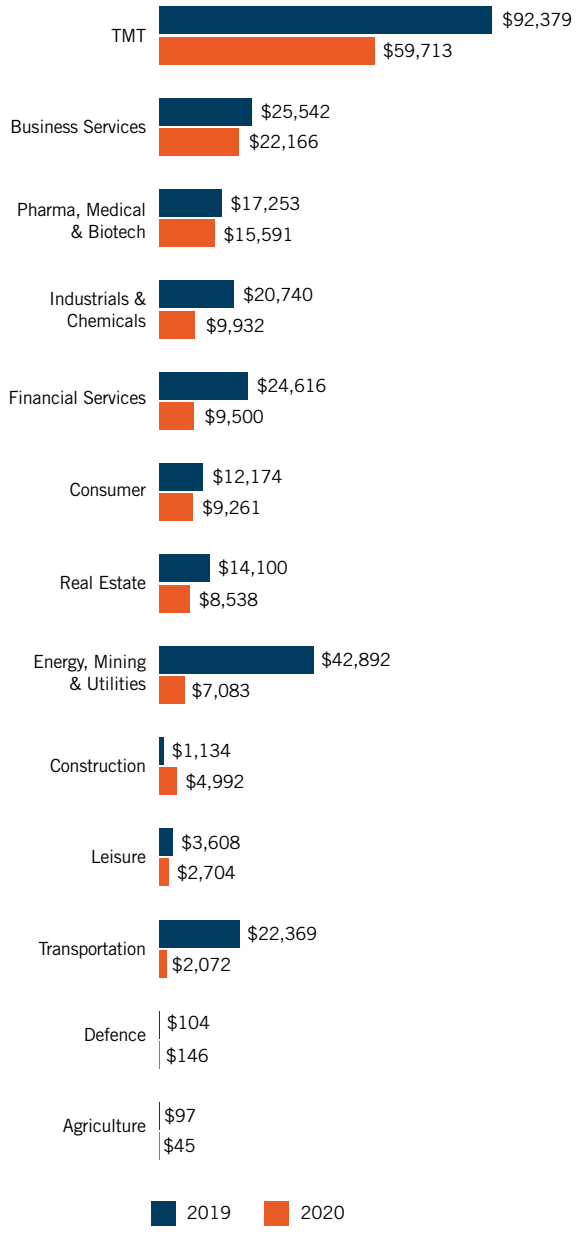
WHICH OF THE FOLLOWING ELECTION OUTCOMES WOULD HAVE THE MOST POSITIVE IMPACT ON THE PE MARKET IN THE NEXT 12-18 MONTHS?



WHICH OF THE FOLLOWING ELECTION OUTCOMES WOULD HAVE THE MOST NEGATIVE IMPACT ON THE PE MARKET IN THE NEXT 12-18 MONTHS?



PE BUYOUT VALUE BY SECTOR IN NORTH AMERICA (US$M), 2019 - Q3 2020



Private debt: Credit markets adjust

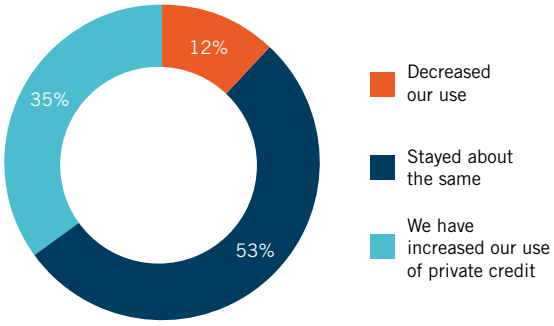
The long-term growth of private credit has been nothing short of stratospheric. In 2000, the market scarcely existed, worth at the time little more than US$40bn. Today that has ballooned to more than US$800bn. This has been propelled by direct lending funds, which have grown in number and size in tandem with the leveraged buyout market they almost exclusively finance. GPs have grown accustomed to the benefits of this source of deal financing, such as looser covenants and more generous leverage ratios, in spite of the higher cost of capital that comes with those advantages. Indeed, 30% of firms surveyed believe that greater flexibility on financing terms is the greatest advantage of using private credit, and 30% see the ease of execution as the top benefit.

More than half (53%) of respondents say that the use of private credit financing in buyouts stayed the same over the last three years, indicating the normalization of the use of these debt products in recent years, while 35% have increased their use of these loans over the same period. Nearly half (49%) of firms now use roughly equal amounts of private credit and traditional bank financing in their buyouts deals.

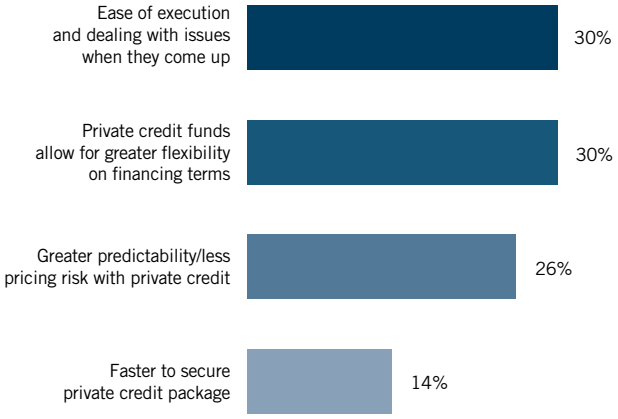
The demand among investors for direct loans, the most common type of private credit strategy, has been exceptionally high in recent years. Private debt's high cash yields are especially attractive to investors in a low-rate environment. This demand has meant most multi-strategy marquee PE houses have added credit to their offerings,

In 2000, the private credit market scarcely existed, worth at the time little more than US$40bn. Today that has ballooned to more than US$800bn.

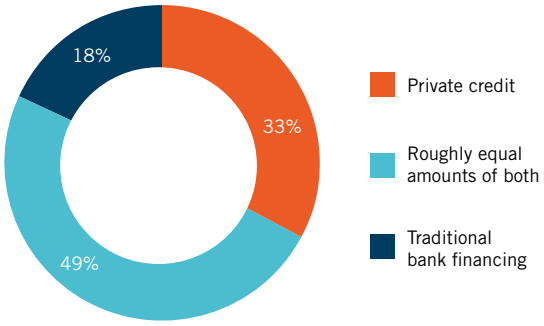
OVER THE LAST THREE YEARS, HOW HAS YOUR FIRM'S USE OF PRIVATE CREDIT FINANCING IN BUYOUTS CHANGED, IF AT ALL?



IN YOUR OPINION, WHAT IS THE GREATEST ADVANTAGE OF USING PRIVATE CREDIT AS COMPARED TO TRADITIONAL BANK FINANCING CURRENTLY?



DOES YOUR FIRM USE PRIVATE CREDIT OR TRADITIONAL BANK FINANCING MORE OFTEN IN ITS BUYOUT DEALS?



as they have sought to scale up assets under management, and diversify their product offerings and channels of distribution, building larger fee-generating businesses. This trend has passed down the food chain to smaller, mid-market managers and in many cases private debt has been the obvious first choice among GPs for asset diversification.

The impact of the pandemic has been felt in the private credit markets although it has been relatively short-lived. The wider leveraged finance market responded to swift government and central bank action to backstop markets and support companies through bond and loan purchases. March, April and May were challenging months, just as they were for buyout activity, but there has since been something of a rebound. June's institutional loan issuance surpassed that of March, April and May combined.

However, this recovery has not been across the board nor without compromise. While debt markets have bounced back to pre-pandemic levels in EMEA markets, borrower terms have remained somewhat tightened in the US. Lenders are being more selective, gravitating towards companies whose business models have not had material weaknesses exposed by the pandemic.

Spotlight on EMEA

The EMEA region sits between APAC and North America with regard to the effect the pandemic has had on its deal market and in terms of its crisis response. While its major countries may not have handled the crisis as swiftly and assuredly as many regions in Asia including China, South Korea and Taiwan, the likes of Germany, Italy and France contained the virus more effectively than the US—although a second wave of the pandemic is posing fresh challenges.

Total buyout value across the three quarters was impressively resilient, rising by 2% to a total of US$244.1bn, compared to Q1–Q3 2019. Volume dropped by 17% over this period to 1,716 deals—still a less stark rate of decline than global buyout volumes.

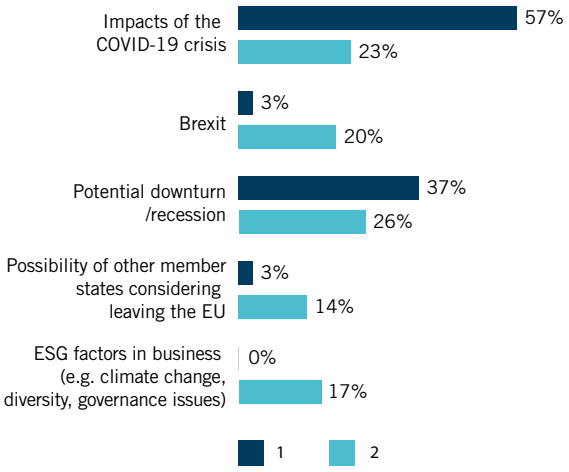
The robust levels of total buyout value were boosted by one of the largest buyouts Europe has ever seen: the US$18.8bn carve-out of ThyssenKrupp's elevators business by Cinven, Advent International and coal mining trust RAG-Stiftung. The deal was agreed in late February, before the COVID-19 outbreak was formally recognized as a global pandemic.

This club deal ensured the top sector by value was industrials & chemicals with US$42.1bn invested. It also hints at what might be expected in the coming months, as funds seek deployment opportunities for their still historic sums of dry powder.

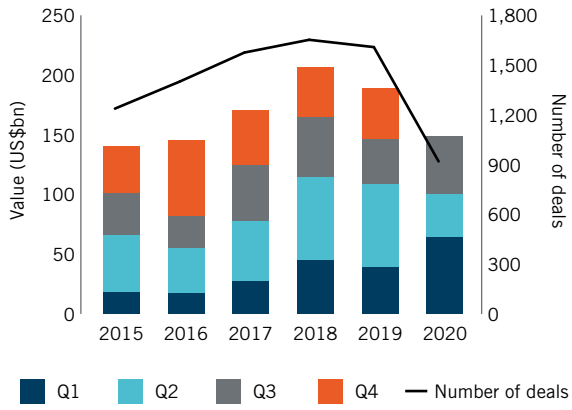
Over the past three years, activist shareholders have increasingly taken positions in European companies, often advocating for corporate break-ups—thus contributing to an increase in European carve-out activity. Now, credit downgrades in 2020 and the opacity of the earnings outlook mean that corporates will be reviewing their operations with heightened scrutiny. Any non-core or inefficient business units are likely to be sold to optimize balance sheets and reallocate capital in anticipation of continued recessionary pressures or shocks.

This shows that the impact of the pandemic on PE markets is unlikely to be entirely detrimental, as the dislocation can spell opportunity, in spite of the fact that over half (57%) of EMEA respondents point to the impacts of the COVID-19 crisis as the development that will have the biggest effect on the deal environment in the next 12–18 months, with a further 23% choosing it as the second most important factor.

IN YOUR ESTIMATION, WHICH CURRENT OR UPCOMING DEVELOPMENTS IN EMEA WILL HAVE THE BIGGEST EFFECT ON THE DEAL ENVIRONMENT OVER THE COMING 12–18 MONTHS?



NUMBER AND VALUE (IN US$BN) OF PE BUYOUT DEALS IN EMEA, 2015 – Q3 2020

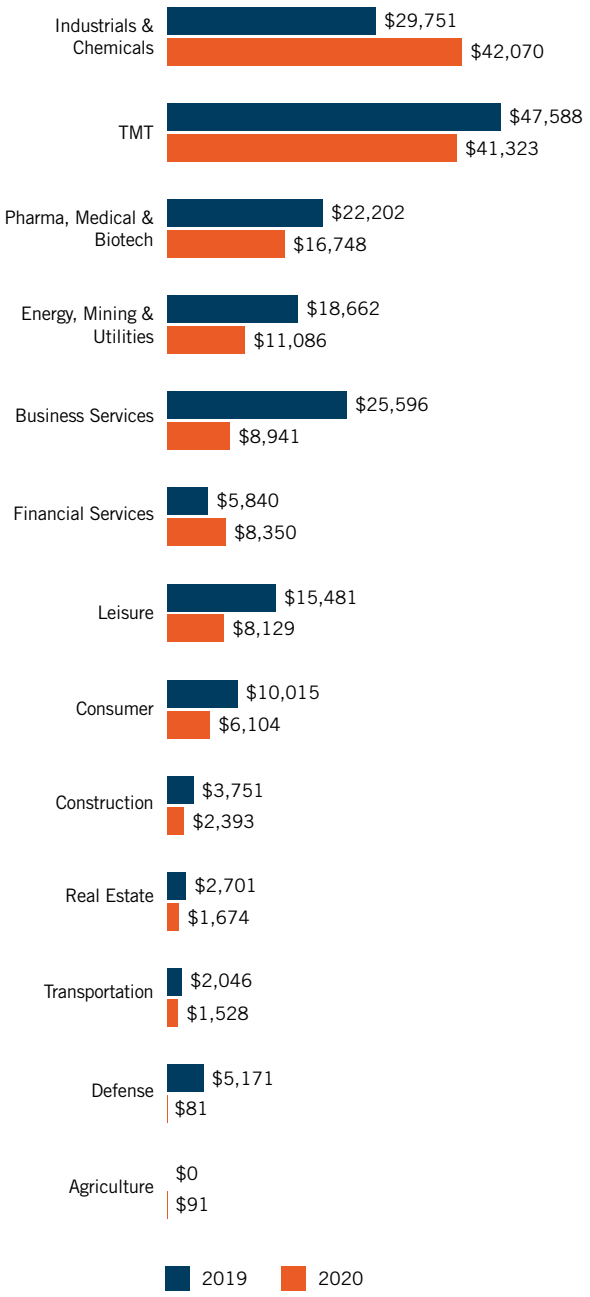


This is higher than in APAC or North America, where 20% and 33% of respondents, respectively, ranked this as having the biggest effect on the deal environment.

Brexit, meanwhile, is not on the forefront of investors' minds. Only 3% of respondents said the UK's departure from the EU would have the biggest effect on the deal environment, although a further 20% picked it as the second most important factor, behind the potential for a downturn/recession (26%) and the impacts of the COVID-19 crisis (23%).

The UK formally left the EU in January but is still in a one-year transition period. The biggest remaining point of contention surrounds what trading arrangements, if any, will be put in place at the end of the transition period and whether companies will be free to trade without additional tariffs. There is less concern about the impact of Brexit on M&A processes, as the UK's body of legislation and regulations will remain the same until policymakers pass new laws. Instead, it is the performance of portfolio companies importing and exporting between the UK and the EU, that is likely to be more adversely affected.

PE BUYOUT VALUE BY SECTOR IN EMEA (US$M), 2019–Q3 2020



Exits: Realizing value

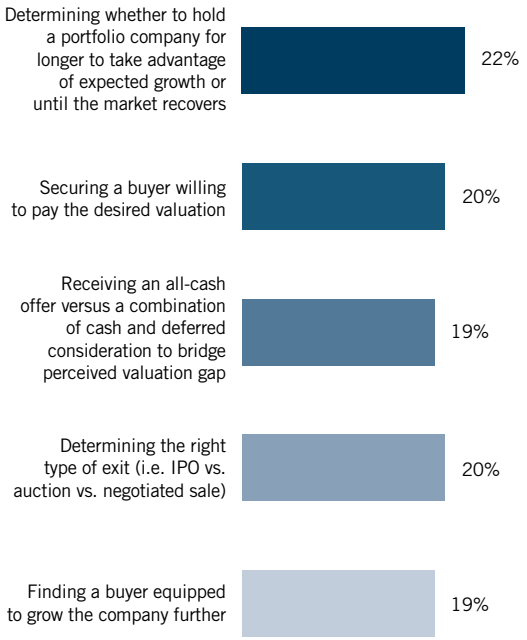
In a typical recessionary environment, PE firms can be expected to hold onto portfolio companies until exit conditions improve. This was reflected in our survey, conducted in July and August: nearly a quarter (22%) of respondents think that determining whether to hold a portfolio company for longer to take advantage of expected growth or until the market recovers will be one of the biggest challenges to exiting portfolio companies over the coming 12 months, followed by securing a buyer willing to pay the desired valuation (20%).

Against this background, the US$232.9bn worth of exit activity announced in Q3 was a welcome surprise. This total was not only a 517% increase quarter on quarter, it also marks the highest quarterly exit total for several years.

The number of exits also rose quarter on quarter, by 47%, to 454 deals. Year on year, the number and value of PE exits were still lower—there were 1,290 transactions worth US$369.8bn in the first three quarters of the year, a 31% decrease in volume and a 6% drop in value—but these figures remain remarkably strong when considering the tough trading conditions in many industries in the wake of the pandemic.

Nor were these exits necessarily an example of selling low. Among the largest exits of the year was PE firm Thoma Bravo's sale of mortgage software platform Ellie Mae to Intercontinental Exchange (ICE), the operator of the New York Stock Exchange. The US$11bn deal came less than two years after Thoma Bravo acquired the asset for US$3.3bn.

WHAT IS THE BIGGEST CHALLENGE YOU EXPECT TO FACE WHEN IT COMES TO EXITING INVESTMENTS OVER THE COMING 12 MONTHS? (SELECT TOP TWO)



Whether this rate of exit activity can be sustained remains to be seen. When surveyed, two in five respondents (39%) were pessimistic about the exit environment, saying market conditions for exits will be very unfavorable over the coming 12 months, almost double the 20% who said the same in last year's survey.

Although exit volume and value were robust in Q3, the simultaneous rise in add-on transactions suggests that while some PE owners have found the exit environment more favorable than predicted, others will be looking to add value to their assets before bringing them back to market.

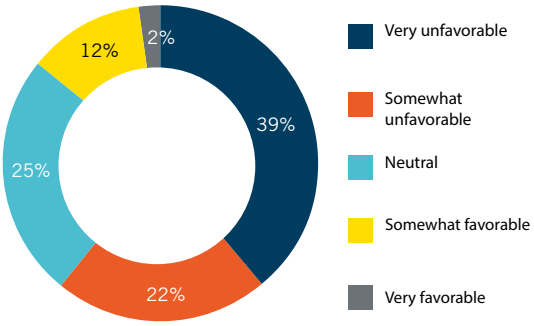
Rather than simply riding out the storm and bringing assets back to market when conditions improve, there is an incentive to return to the drawing board by fundamentally improving assets before their eventual sale. With dry capital at such high levels and financing still plentiful, PE firms can be opportunistic and focus on asset development—especially if market conditions for exits prove more challenging.

A major factor underpinning the success of those companies that have flourished in 2020 is technology. The digitalization of operations, products, and services was a trend that was already evident prior to 2020, but this will now be pursued with a new sense of urgency. Any fund managers that had neglected the digital transformation of their portfolio companies now have little option but to review how technology can enable and enhance their existing assets.

This does not mean positioning non-tech businesses as technology companies. Rather, technology is an enabler. GPs can create significant value—and increase exit potential—even if these digitalization programs have been initiated but not completed. This is especially true for sponsor-to-sponsor trades, where the incoming fund can finish what was started by the exiting fund, capturing value for their own LPs.

Business models will now be under close review and material weaknesses laid bare by the pandemic will need to be addressed. For instance, GPs may seek to diversify revenue sources to minimize the cyclicality of their businesses. They may also be forced to push through strategic pivots to more robust sales models—for example, away from one-off purchase models towards subscription arrangements that deliver more resilient, repeatable sales.

HOW DO YOU THINK THE MARKET CONDITIONS WILL BE FOR PRIVATE EQUITY EXITS OVER THE COMING 12 MONTHS?



In this way, the events of 2020 have the potential to refocus PE's efforts on the fundamentals of company improvement. While this may result in extended holds, it should also deliver higher-quality companies, drawing greater interest from buyers at the point of exit.

Conclusion: Coping with uncertainty

The pandemic of 2020 and its scale and reach has few precedents. Lockdown responses have had an immense impact on the economy and capital markets. But these appear to be momentary shocks concentrated in Q2 when global lockdown measures were being most strictly enforced.

Q3 saw a burgeoning recovery in buyout activity and leveraged financing markets. This recovery is far from guaranteed. A resurgence of COVID-19, the US presidential elections and ongoing geopolitical fractures all pose significant threats to dealmaking activity. However, abrupt and full lockdowns are less likely given the immense economic cost they have had and the better understanding that scientists, health authorities and governments have of containing the virus.

Ultimately, PE funds still have dry powder to invest and are far more agile and less risk averse than their corporate counterparts, as demonstrated by the rise in buyout activity in Q3.

Going forward, they are better positioned than corporates to weather whatever may come. If debt is difficult to secure, especially for deals in more stressed sectors, PE funds can fund deals entirely with equity and refinance the portfolio company when conditions improve. Similarly, although the exit environment has proved more benign than expected, if market conditions were to take a turn for the worse, GPs will be able to re-strategize and reposition their existing portfolio companies for sale in the post-COVID-19 world. Those fund managers who successfully navigate the challenges posed by the events of 2020 will be the ones who secure their positions in the PE industry over the next economic cycle.

Hands-on portfolio management

Funds have already staved off the immediate impacts of lockdowns on their portfolio companies by providing necessary liquidity and strategic and operational expertise. Moving forward, businesses remain at significant risk of ongoing earnings pressure. This is especially true of stricken sectors that face a long and challenging recovery. This will require judicious management of capital structures and keeping open dialogue with creditors to protect value in existing assets.

Prioritizing investor communications

LPs will prioritize managers that have provided transparent communication during the recent period. NAV calculations inherently vary in private markets as valuations are open to a degree of interpretation. But, where possible, GPs should not attempt to manage expectations, instead providing realistic prognoses of portfolio health and value protection and creation. Investors will want to know that the situation is under control and see evidence of this.

Repurposing business models

It is not only technology that will better position companies for future exit. Strategic pivots into adjacent markets, diversifying revenue streams and adapting customer contract models all have the potential to make businesses more salable. PE managers will have to determine what strategies they consider will be most effective for the long-term prospects of their companies and then set about executing them. There is no time to waste.

Going digital

If fund managers did not recognize the need to digitally transform their portfolio companies, they do now. Over the next 24 months, expect GPs to make digitalization a first order of priority. Analog business models that rely excessively on human interaction will not appeal to buyers. PE firms will therefore seek ways that their investments can harness technology to improve operations, products and service delivery to ensure their strategic relevance.

Creative dealmaking

Corporates are showing significant interest in raising cash through divestments as their earnings come under pressure and their leverage ratios increase. PE will be the prime beneficiary of this. Firms that have dry powder to deploy and are able to execute on atypical transactions stand to make outsized returns after the significant repricing effects of the pandemic. Minority investments are becoming more popular – both to dip the toes into the water as well as providing structured equity solutions to underperforming companies.

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